

BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

KALISPELL ASSOCIATES)	
LIMITED PARTNERSHIP,)	
dba MERIDIAN POINTE)	DOCKET NO: PT-1995-21
)	
Appellant,)	
)	ORDER ON REMAND
-vs-)	
)	
THE DEPARTMENT OF REVENUE)	FINDINGS OF FACT,
OF THE STATE OF MONTANA,)	CONCLUSIONS OF LAW,
)	ORDER and OPPORTUNITY
Respondent.)	<u>FOR JUDICIAL REVIEW</u>

The above-entitled appeal came before the Montana State Tax Appeal Board (the Board) for hearing on remand on the 18th day of November, 1997, in the City of Helena, Montana, pursuant to the Remand Order of Judge Dorothy McCarter, Montana First Judicial District, Lewis and Clark County. The notice of the hearing was given as required by law. The taxpayer, represented by attorneys David Weiner and Terry Cosgrove, presented testimony in support of the appeal. The Department of Revenue (DOR), represented by attorney Bruce McGinnis, Region 2 Manager Scott Williams, and Commercial Appraiser Harvey Paugh, presented testimony in opposition to the appeal.

At this time and place, testimony was presented.

FINDINGS OF FACT

1. The taxpayer raises before the District Court two assertions of error on the part of the State Tax appeal Board (STAB): 1) the STAB failed to require the Department to use the income method in its valuation of Meridian Pointe, and 2) the STAB failed to require the Department to include certain considerations in its application of the cost method. (Order, pg. 3)

2. In summary, the Remand Order states:

- A. The STAB's decision contains fatal deficiencies. First, it fails to address the requirement that the Department apply the income approach if it is able to do so and, second, the decision does not state reasons why the income approach could not be used.

The result of the Department's blanket application of the cost approach to all properties in Flathead County without sufficient explanation, simply leaves the Taxpayer in the dark as to the basis and makeup of the property assessment and also leaves the Taxpayer subject to unexplained and unsubstantiated practices of the Department in assessing the property.

- B. The STAB's next error is its omission of any decision or discussion as to whether economic obsolescence or restrictions imposed on Meridian Pointe by the section 42 program should have been factored into the Department's valuation of the property.

DOR'S CONTENTIONS

Mr. Williams stated that in the process of reappraisal for the 1993 appraisal cycle, the DOR sent two mailings out to all commercial property owners. He said these mailings were an attempt to obtain income and expense data to be used in the development of income models for the valuation of commercial properties. The first mailing was sent out in November of 1991 and the second in April of 1992. Mr. Williams stated that the response generated from these mailings was "very poor" and "less than 10% of the forms returned, of those 10% that they returned the information on them that was usable was limited." He testified that the usable information was sent to Helena where the income models were being created. Mr. Williams testified that a working model was never implemented in Flathead County; since values from the income approach for all properties could not be created, it was determined for equity purposes that the cost approach would be used to determine market value.

Mr. Williams testified the DOR gave no consideration to a value reduction for the subject property with regards to the government restrictions on the amount of rent which can be collected. He went on to say that there is no considerable

difference in the rents charged by the subject property versus other complexes. Mr. Williams testified, "There is no true information out there which would support any kind of valuation decrease based on a burden that the government would control on this. There is no sales information which is present that would support that claim."

TAXPAYER'S CONTENTION

Mr. Weiner contends that the DOR did not properly value the subject property; and the appropriate value is determined by the taxpayer to be \$1,211,240, which includes land and improvements. This value determination is from an income approach to value which utilized a 10.5% capitalization rate along with a 1.9% effective tax rate. Mr. Weiner testified that there is a correlation between the presence of economic obsolescence as determined by Mr. McBurney and the Supreme Court's decision, Department of Revenue v. Grouse Mountain Development, ruling on governmental restrictions on "use".

Mr. Weiner stated that the "tax credits are not a part of valuing ad valorem real property." He further testified, "financing is not a function in value, in valuing real property." Mr. Weiner argued, "The regulations of the

Department of Revenue, State of Montana, says that debt service is not an expense from the income approach...it can only be concluded that if debt service is not an expense for the income approach, financing from whatever source can't be a function of market value."

DISCUSSION

The DOR in Flathead County attempted to create an income model for multifamily properties. Income and expense data was requested from commercial property owners. The DOR relied on two separate mailings to obtain this data.

Mr. Williams indicated that the DOR did not solicit income and expense data from other real estate professionals. ARM (Administrative Rules of Montana) 42.20.108 states, in part:

(d) Additional methods of obtaining income and expenses information may consist of personal contacts or telephone contacts with owners, tenants, renters or leases, knowledgeable lending institution officials, real estate brokers, fee appraisers, or any other sources the appraiser deems appropriate including summarized data from recognized firms who collect income and expense information, and appeal or court actions.

The DOR had the ability to expand its research and data collection beyond the mailings which were sent to commercial property owners. From the testimony of Mr. Williams, the DOR relied solely on mailings which were returned

to the DOR and which were deemed to contain insufficient data to develop an income model.

The statement in the ARM, 42.20.107 that the DOR will consider the income approach to valuation does not mean that it will be the sole approach to valuation. That is clear upon reading the ARM, 42.20.107 on industrial property which is restricted to utilizing the cost approach to value.

The ARM allow the DOR to utilize the income approach when it has the tools to do so. The DOR did not have the data required to do income modeling necessary to perform income based appraisals on commercial property. This Board does not condone the fact that, when challenged by the lack of returns from property owners to the DOR mailings, the DOR did not compile the economic data available through other means. It is certainly not necessary to rely solely on the Computer Assisted Mass Appraisal System (CAMAS) generated models to provide for accurate values in a given area. The appraisal staff living and working in the Flathead area should be able, through knowledge of the market, economic conditions, and appraisal training, to perform such valuations.

The Montana Supreme Court has addressed the issue of

sole use of the income approach in valuing commercial property:

For the valuation of commercial property, CAMAS produces a cost estimate and, in some instances, an income estimate. The income approach to valuation is the preferred method of valuation of commercial properties in Montana. The Department's process for income valuation of commercial property begins with the submission of income and expense questionnaires to commercial property owners to complete and return. The information on the statements is reviewed by an appraiser and entered into the CAMAS system. Once in the computer, it can be sorted and analyzed using selectability criteria. The information is then correlated and commercial income models are developed. Such models may only be created, however, in areas where sufficient income and expense data has been collected. Because commercial property owners are not required to provide such information to the Department, the income approach to commercial property valuation in Montana is limited to those six counties in Montana in which ample data exists.¹ In all other counties in Montana, commercial property is valued using the cost approach to valuation.² Although the Department's appraisal plan provides that commercial property may also be estimated by the market data approach, the Department has not developed and market models for commercial property in Montana. Therefore, the CAMAS system estimates commercial property values based on either the income approach in six Montana counties or the cost approach in the remaining counties. The evaluation approach for commercial property and its estimated market value, as established by that method, are set forth on a "Property Record Card," which is available for review by the commercial property owner. Albright v. State of Montana, 933 P.2d, 815, (Mont 1997)

The property under appeal was built in 1994; therefore, physical depreciation should be extremely low and the functional utility should be very good. If the value is diminished, it would most likely be from an external, or economic reason and be reflected in an economic condition

¹ In Montana, the income approach is applied only in Yellowstone, Cascade, Custer, Anaconda-Deer Lodge, Missoula, and Butte-Silver Bow Counties.

² This system of commercial property valuation is approved by the Department's Administrative Rules. For example, Rule 42.20.107, ARM, provides:

(1) When determining the market value of commercial properties, other than industrial properties, department appraisers will consider, if the necessary information is available, an income approach valuation.

(2) If the department is not able to develop an income model with a valid capitalization rate based on the stratified direct market analysis method, the band-of-investment method of collect sound income and expense data, the final value chosen for ad valorem tax purposes will be based on the cost approach, or if appropriate, the market approach to value

factor (ECF).

The Court again addressed the matter of the Economic Condition Factor in Albright:

The Department of Revenue applies ECFs to adjust both residential and commercial property valuation where the cost approach is used. An ECF is calculated for residential property by comparing an estimation of values using the market approach to an estimation of values using the cost approach. The ratio determined by dividing the average market value by the average cost value is the ECF. An ECF is calculated for commercial property by comparing an estimation of the average sales price to an estimation of the average cost value. The ratio determined by dividing the average sales price by the average cost value is the ECF. ECFs apply only to the depreciated reproduction or replacement cost of the improvements to the land, and not to the value of the land itself. ECFs are not used for those residential properties whose value is determined by the market value approach or for those commercial properties whose value is determined by the income approach. In addition, ECFs are never applied to industrial property valuation. Albright v. State of Montana, 933, P2d, 815, (Mont 1997)

The DOR utilized the cost approach in this property - 15-8-111 (2)(b) states in pertinent part:

15-8-111, MCA. (b) If the department uses construction cost as one approximation of market value, the department shall fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence.

International Association of Assessing Officers, (IAAO), Property Assessment Valuation, 1977, pg. 160 states:

Methods of Measuring Depreciation

The translation of the value loss from accrued depreciation is one of the most questionable aspects of the appraisal process. There are six methods used to measure accrued depreciation; each has advantages and disadvantages and varies in reliability. They are categorized as follows.

Indirect Methods

1. Comparative sales data method
2. Capitalization of income method

Direct Methods

3. Overall (age-life) method
4. Engineering breakdown method
5. Observed condition (breakdown) method
6. Depreciation tables

IAAO states:

Methods of Measuring Depreciation

Capitalization of income method - income of the subject property is capitalized into estimate of value, with the site value deducted; indicated building value is compared with estimated reproduction or replacement cost new to provide indication of building value remaining.

Neither the taxpayer nor the DOR presented sales of housing projects developed with tax credits which would recognize depreciation in all forms. The DOR applied an ECF of 113% which this Board Order removed in its decision PT-1995-21, of May 8, 1996. Don McBurney, who testified and presented exhibits at the original Board hearing, is a certified real estate appraiser in the State of Montana and stated at the hearing that his capacity before this Board was a consultant and not a valuer. Mr. McBurney did however present a value indication that was derived from the income approach to value. (exhibit #6) In addition, Mr. McBurney arrived at an economic obsolescence of 44.29% by subtracting his value indication from the DOR's value, then dividing the difference by the DOR's value to arrive a percentage of economic obsolescence.(exhibit #6). Mr. McBurney's economic obsolescence factor is dependent upon his capitalization rate since the value was determined by

the income approach to value; therefore, it is imperative that the appropriate capitalization rate be applied.

Overall capitalization rates can be estimated through various methods; the method used depends on the quality and quantity of data available. Mr. McBurney used the band-of-investment method to arrive at an overall capitalization rate of 10.5%:

Mortgage @ 9.375% (30 year mortgage amortization)
80% loan to value ratio

Loan	80%	X	9.375%	=	.075
Equity	<u>20%</u>	X	2.5%	=	<u>.005</u>
	100%				8%

Recapture 1/40 years	=	<u>2.5%</u>
Overall Rate		10.5%

In this case the taxpayer provided actual income and expense data and, when asked if the above reflects actual financing, the taxpayer's agent responded that this is not the actual financing for the subject property. He indicated that the above illustration is what can be considered typical in the market at the time of this Board's first hearing. The taxpayer's agent indicated that at the time of the hearing the financing had not been secured since a second phase to the subject property was being developed.

Capital for this project was raised by the selling of

Federal Income Tax Credits to investors. The amount of equity will undoubtedly affect the overall capitalization rate from the band-of-investment method if actual financing is considered. It is this Board's opinion that, because of the unusual characteristics surrounding the financing of this property, i.e. tax credits sold to provide equity financing, the actual financing arrangements should be considered in determining the overall capitalization rate from the band-of-investment.

If the actual income and expenses are to be considered in determining the value, the in-place financing should be used. The amount of equity generated from the sale of the tax credits may certainly affect the value from the income approach. If, for example, 50% of the project was financed through the sale of the tax credits, the development of the capitalization rate by the band-of-investment will differ from what the taxpayer provided in exhibit #6. That, in turn, would result in a lower rate, resulting in a different economic obsolescence factor. Testimony indicated approximately 50% of the subject property's development costs were generated through the sale of tax credits.

The Board agrees with Mr. Weiner that the tax credits

themselves are not part of the valuation process for the subject property; however, the amount of equity generated through the sale of those tax credits most certainly affects the value of the subject property when using the income approach because of the equity position.

The revenue-generating ability of a property is often fixed or limited by the terms of existing leases. With respect to the subject property, Kalispell Associates essentially has a lease agreement with the government as to the amount of rent which may be collected. With this rent restriction, the effective gross income likely would be less than normal. The expenses can be expected to be somewhat typical. With lower rents and typical expenses, therefore, the net operating income would be less.

The next step in the income approach is to convert net operating income into value with the appropriate capitalization rate. It is this Board's opinion that, if actual financing were used in the taxpayer's band-of-investment (exhibit 6), a different value indication would have resulted along with a different economic obsolescence factor.

This Board disagrees with Mr. Weiner's statement that, "Debt service is not a component of an income approach to

valuation". Debt service was utilized in the determination of an overall capitalization rate and is illustrated in taxpayer's exhibit #6.

The Appraisal of Real Estate, Eleventh Edition, pg 461, states:

Direct capitalization is a method used to convert an estimate of a single year's income expectancy into an indication of value in one direct step-either by dividing the income estimate by an appropriate income rate or by multiplying the income estimate by and appropriate income factor.

Direct capitalization is market-oriented. The appraiser analyzes market evidence and values property by inferring the assumptions of typical investors.

The taxpayer's agent in this case has used actual income and expenses and capitalized that income indication with a market derived rate.

It is this Board's opinion that the taxpayer's method of determining the amount of economic obsolescence of 44.29% ($\$1,970,600 - \$1,097,875 = \$872,725$; $\$872,725 / \$1,970,600 = 44.29\%$) is not supported by any factual evidence nor is it recognized that using actual and market data to arrive at a value indication is an accepted method in the appraisal industry.

Mr. Weiner stated that there is a correlation between the presence of economic obsolescence as determined by Mr. McBurney and the Montana Supreme Court decision in, Department

of Revenue v. Grouse Mountain Development, 218, Mont. 353. The Grouse Mountain Development case dealt with governmental restrictions on "use". The Board reviewed that decision and found that the appraiser, Roger Jacobson used sales of similar properties and made the necessary adjustments:

Grouse Mountain Development and Gratten commenced construction of a nine-hole golf course adjoining the residential subdivision. In order to secure financing for the project, Grouse Mountain Development had to encumber all of the property, including the golf course, with a mortgage. Gratten could not develop the residential area unless he convinced the City of Whitefish to annex the area to the City so that the lots would be served by city water and sewage. The City passed ordinance A-333 which required the developer to grant a perpetual use of the golf course to the public as a condition to annexation...

In the instant case, the State Tax Appeal Board rejected the appraisal of Roger D. Jacobson, respondents' fee appraiser, who valued the land and improvements at \$50,000. The methodology used by the appraiser was primarily a market data approach based on comparable sales. He found four golf courses that had sold in northwestern Montana in the years 1977 and 1978. Allocations were made for the swimming pools and additional land available for subdivisions. He also took into account the age of the courses and the time factor involved and arrived at a value of \$20,000 per hole.

The appraiser then considered the effect of the public use restrictions on the value of the property. The appraiser found that this limitation on use greatly decreased its value to a willing buyer. He then sought sales of land likewise restricted in use to determine the effect of such use restriction on the value of the land. The appraiser found that the use restriction on the subject property reduced its value to 20 to 30% of its value had no restriction existed.

There were no sales presented to support the taxpayer's claim of economic obsolescence present in the amount of 44.29% or any other amount upon which this Board could rely. In addition, Grouse Mountain Development is subject to a "perpetual easement", whereas the subject property's rents can be converted to market rates after 15 years and can be sold as a market oriented housing facility.

Based on the evidence and testimony presented, it is the opinion of this Board that no further adjustment in value of the subject property is warranted other than the removal of the 113% ECF in the decision, PT-1995-21 of May 8, 1996.

CONCLUSIONS OF LAW

(1) **15-8-111, MCA**, Assessment - market value standard - exceptions. (1) All taxable property must be assessed at 100% of its market value except as otherwise provided.

(2) (a) Market value is the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

(b) If the department uses construction cost as one approximation of market value, the department shall fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence.

(2) **15-1-101 MCA**, Definitions (1) Except as otherwise specifically provided, when terms mentioned in this section are used in connection with taxation, they are defined in the following manner:

(e) The term "comparable property" means property that:

(i) has similar use, function, and utility;

(ii) is influenced by the same set of economic trends and physical, governmental, and social factors; and

(iii) has the potential of a similar highest and best use.

(o) The term "property" includes money, credits, bonds, stocks, franchises, and all other matters and things, real, personal, and mixed, capable of private ownership. (emphasis supplied)

(3) **15-6-101 MCA**, Property subject to taxation - classification. (1) All property in this state is subject to taxation, except as provide otherwise.

(4) **ARM 42.20.107**, Valuation Methods for Commercial Properties.

(1) When determining the market value of commercial properties, other than industrial properties, department appraisers will consider, if necessary information is available, an income approach valuation.

(2) If the department is not able to develop an income model with a valid capitalization rate based on the stratified direct market analysis method, the band-of-investment method or collect sound income and expense data, the final value chosen for ad valorem tax purposes will be based on the cost approach to value. The final valuation is that which most accurately estimates market value.

(5) **ARM 42.20.108**, Income Approach (1) The income approach is based on the theory that the value of income producing property is related to the amount, duration, and certainty of its income producing capacity. The formula used by the department to estimate the market value of income producing property through application of the income approach to value is $V = I/R$ where:
(a) "V" is the value of the property to be determined by the department.

(b) "I" is the typical property net income for the type of properties being appraised; and

© "R" is the capitalization rate determined by the department as provided in ARM 42.20.109.

(2) The following procedures apply when valuing commercial property using the income approach:

(a) Typical property net income "I" shall reflect market rents not investment value income or other rents.

(b) Market rent is the rent that is justified for the property based on an analysis of comparable rental properties and upon past, present, and projected future rent of the subject property. It is not necessarily contract rent which is the rent actually paid by a tenant.

© The department will periodically request gross rental income and expense information from commercial property owners. Standard forms, developed by the department, will be used to collect the information statewide. Copies of those forms may be obtained by contacting the Department of Revenue, Property Assessment Division, Mitchell Building, Helena, Montana 59620.

(d) Additional methods of obtaining income and expenses information may consist of personal contacts or telephone

contacts with owners, tenants, renters or leases, knowledgeable lending institution officials, real estate brokers, fee appraisers, or any other sources the appraiser deems appropriate including summarized data from recognized firms who collect income and expense information, and appeal or court actions.

(e) The department will review and analyze all annual rental income and expense data collected. As necessary, that data will be adjusted to reflect average conditions and management before entering the data into the computer assisted mass appraisal system. The process must result in defensible estimates of potential gross rents, effective gross incomes, normal operating expenses, and normal net operating incomes.

(f) The department will follow established procedures for validating commercial sales information for the development of income models. Only valid sales will be used for the income and expense module of the computer assisted mass appraisal system.

(3) the department will use generally accepted procedures as outlined by the International Association of Assessing Officers in their titled "Property Assessment and Appraisal administration" when determining normal net operating income. The following is an example of the format which will be used:

(a) potential gross rent

less	vacancy and collection loss
plus	miscellaneous income
equals	effective gross income
less	normal operating expenses
equals	normal net operating income

(b) Normal and allowable expenses include the cost of property insurance; heat, water, and other utilities; normal repairs and maintenance; reserves for replacement of items whose economic life will expire before that of the structure itself; management; and other miscellaneous item necessary to operate and maintain the property.

© Items which are not allowable expenses are depreciation charges, debt service, property taxes and business expenses other than those associated with the property being appraised.

(d) An effective tax rate will be included as part of the overall capitalization rate. (emphasis supplied)

(6) **ARM 42.20.109**, Capitalization Rates (1) When using the income approach, the department will develop overall

capitalization rates which may be according to use type, location, and age of improvements. Rates will be determined by dividing the net income of each property in the group by its corresponding valid sale price. The overall rate chosen for each group is the median of the rates in the group. The final overall rate must include an effective tax rate.

(2) (a) If there are insufficient sales to implement the provisions of ARM 42.20.109 (1), the department will consider using a yield capitalization rate. The rate shall include a return of investment (recapture), a return on investment (discount), and an effective tax rate. The discount is developed using a band-of-investment method for types of commercial property. The band-of-investment method considers the interest rate that financial institutions lend on mortgages and the expected rate of return and average investor expects to receive on their equity. This method considers the actual mortgage rates and terms prevailing for individual types of property.

(b) A straight-line recapture rate and effective tax rate will be added to the discount rate to determine the yield capitalization rate.

(7) Albright v. State of Montana, 933, P2d, 815.

(8) Department of Revenue v. Grouse Mountain Development, 707, P2d, 1113.

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ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the value of the subject property shall be entered on the tax rolls of Flathead County by the Assessor of said County consistent with the Board's Order, PT-1995-21 dated May 8, 1996.

Dated this _____ of January, 1998.

BY ORDER OF THE
STATE TAX APPEAL BOARD

PATRICK E. McKELVEY, Chairman

(S E A L)

GREGORY A. THORNQUIST, Member

LINDA L. VAUGHEY, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this _____ day of January, 1998, the foregoing Order of the Board was served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

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